WORKING PAPER

No. 10-09 MGT          October 2010

Auditing for Usefulness: A New Concern?

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October 14, 2010
Is a New Audit Objective Evolving?

Abstract

This paper argues that recent changes in the U.S. Generally Accepted Accounting Principles (GAAP) hierarchy logically lead to a new audit objective. The elevation of FASB SFAC 1, *The Objectives of Financial Reporting by Business Enterprises*, into GAAP also elevated the objective of providing information useful for making economic decisions into the GAAP hierarchy. Since auditing standards require the auditor to indicate if the financial statements are in conformity with GAAP and GAAP now contains the useful information objective, it is a logical conclusion that the audit report must also indicate if the information in the financial statements is useful for making economic decisions.
Introduction

As with most professions, predicting the future in accounting is somewhat difficult. However, an attempt should be made to consider how efforts in one arena of accounting might impact other arenas—specifically, and relevant to this paper, how changes in the guidance of the Financial Accounting Standards Board may dramatically change the standards of auditing. In light of this, a question should be posed: What effect do the recent changes in the GAAP hierarchy have on the objective of the audit? While at first glance there may seem to be no effect, this paper will show that these GAAP hierarchy changes have a potentially profound effect on the overall audit objective.

The Current Audit Objective

AICPA Professional Standards (AICPA 2009, AU Section 110) state that "the objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles."

In addition, the first standard of audit reporting (AICPA 2009, AU Section 410) requires that "(t)he report shall state whether the financial statements are presented in accordance with generally accepted accounting principles."

Statements of Financial Accounting Concepts
Statements of Financial Accounting Concepts were originally derived by the Financial Accounting Standards Board (FASB) as a theory base on which FASB could base its Statements of Financial Accounting Standards (SFASs). FASB SFASs were GAAP.

Statement of Financial Accounting Concepts (SFAC) 1, Objectives of Financial Reporting by Business Enterprises (FASB 1978, 16-17), stated: "Financial reporting should provide information that is useful ... in making rational investment, credit, and similar decisions."
The Concepts Statements, as originally proposed, did not establish GAAP (FASB 1978, 6).
Therefore, the usefulness objective was not part of GAAP and could have no effect on the audit.

The GAAP Hierarchy as Part of Auditing Standards

Prior to 2008, the GAAP hierarchy was located in Generally Accepted Auditing Standards (GAAS) in AICPA Professional Standards AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles (AICPA 2009). AU Section 411 described GAAP as a four-tiered hierarchy.

The FASB Concept Statements were not identified as part of the four-tiered GAAP hierarchy but instead were classified as other accounting literature and to be considered when no guidance could be found in the tiered GAAP hierarchy (AICPA 2009, AU Section 411). AU Section 411.11 indicated that "the FASB Concepts Statements would be more influential than other sources in this category " (AICPA 2009).

How the GAAP hierarchy came to be under the control of the AICPA reflects back on the origins of GAAP itself. After the stock market crash of 1929, the American Institute of Accountants (AIA), later becoming the AICPA in 1957, took it upon itself to search for accounting principles that had general acceptance. The Securities Exchange Commission
deferred to the AIA to formulate GAAP. Thus, the auditing profession determined both accounting standards and auditing standards from 1934 until 1973.

In 1973 the AICPA abandoned its search for GAAP and helped found the Financial Accounting Foundation. The Financial Accounting Foundation established the FASB. The SEC recognized FASB as the organization to determine GAAP. The auditors, then, were getting out of the GAAP business, yet, the specification of the GAAP hierarchy remained in the auditing standards, and was to stay there until 2008.

**Elevation of the Concepts Statements into GAAP**

The Sarbanes-Oxley Act of 2002 (U.S. House of Representatives 2002, Section 103) set up the Public Company Accounting Oversight Board (PCAOB) to oversee the public accounting profession in the U.S., thereby ending the AICPA’s authority to determine auditing standards for public companies.

In 2008 FASB issued SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles* (FASB 2008). SFAS 162 (FASB 2008) brought the existing GAAP hierarchy into accounting standards at the same time that the hierarchy was deleted from auditing standards for public companies by the PCAOB.

SFAS 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*, (FASB 2009) established the FASB Accounting Standards Codification (ASC) as the only source of authoritative GAAP and also established a two tier GAAP hierarchy: 1) authoritative GAAP and 2) nonauthoritative GAAP. Authoritative GAAP is the Codification itself.
SFAS 168 indicated: "If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources."

SFAS 168 specified nonauthoritative GAAP as consisting of FASB Concepts Statements as well as other items, such as practices widely recognized in an industry, accounting textbooks, and International Financial Reporting Standards (FASB 2009, 3). In the Exposure Draft of SFAS 168 the FASB stated that Concepts Statements would normally be more influential than other nonauthoritative GAAP, but this was eliminated from the final standard (FASB 2009, para A19). In SFAS 168 itself, FASB indicated that FASB may elevate Concepts Statements into the Codification as part of its conceptual framework project but that they would not do this at this time, i.e., 2009 (FASB 2009, para. A19). Yet, the prospect looms that the Concept Statements, while already part of nonauthoritative GAAP, may become part of authoritative GAAP as the FASB and IASB merge their conceptual frameworks. While all SFASs are now superseded by the FASB Accounting StandardsCodification, the content of SFAS 168 has been incorporated into the Codification.

A Contradiction

It must be pointed out that FASB has contradicted itself. SFAS 168 stated: "In the Board's view the issuance of this Statement and the Codification will not change GAAP ... ." Nevertheless, it has changed GAAP, because the Concepts Statements are now explicitly recognized by FASB as part of GAAP. In addition, the Concepts Statements themselves specifically indicate that the Concepts Statements are not part of GAAP. Yet, the Concepts
Statements are now recognized by FASB as a part of GAAP, nonauthoritative GAAP. FASB may even elevate the Concepts Statements into authoritative GAAP via the conceptual framework project. How this contradiction will be resolved is a fundamental issue.

The analysis presented below relies on and assumes to be true that GAAP has been changed and that FASB Concepts Statements are now part of GAAP.

A New Audit Objective

At the present time the objective of the audit is to express an opinion on the fairness of the financial statements in conformity with GAAP. The audit report must state whether the financial statements are presented in accordance with GAAP.

SFAC 1 (FASB 1978) sets the primary objective of financial reporting to be providing information that is useful in making rational investment, credit, and similar decisions. However, via the Codification, SFAC 1 is now part of GAAP, specifically, SFAC 1 is part of nonauthoritative GAAP, but may even be elevated into authoritative GAAP.

The elevation of SFAC 1, The Objectives of Financial Reporting by Business Enterprises, into nonauthoritative GAAP, also elevated the objective of providing information useful for economic decision making into the GAAP hierarchy. Since auditing standards require the auditor to indicate if the financial statements are in conformity with GAAP and GAAP now contains the useful information objective, it seems evident that the audit must address and the audit report must indicate whether or not the information in the financial statements is useful for economic decision making.

In other words, a simple logical inference leads to the conclusion that a new audit objective may be evolving. Maybe the objective of the audit will no longer be, "Do the
statements present fairly..." but instead "Do the statements provide information useful for making rational investment, credit, and similar decisions," because to be in conformity with GAAP the financial statements must provide information that is useful in making economic decisions. And auditing standards require the auditor to indicate if the financial statements are in conformity with GAAP.

"Understandability" in Existing Auditing Standards

Current auditing standards require the auditor to test management assertions regarding presentation and disclosure that are embedded in the financial statements (AICPA, 2006, AU 326). One of these assertions is "Classification and Understandability," which is stated as "Financial information is appropriately presented and described and disclosures are clearly expressed."

Regarding auditor opinion formulation, the AICPA and PCAOB both make references to understandability:

The auditor's opinion that financial statements present fairly ... in conformity with generally accepted accounting principles should be based on his or her judgment as to whether ... the financial statements ... are informative of matters that may affect their use, understanding, and interpretation ..." (AICPA, 411.04; PCAOB 411.04)

In auditing, the objective is to test management's assertions, so, theoretically the auditor is supposed to be auditing "understandability" already. Of course, understandability is not the same as usefulness, but in SFAC 2, the FASB lists understandability in the hierarchy of information qualities (Figure 1) just above "decision usefulness" and relates the two in a fundamental way.
The FASB in SFAC 2 addresses understandability and defines it as "(t)he quality of information that enables users to perceive its significance (FASB, 1980, 11)." The FASB has stated that it "is concerned with qualities of information that relate to broad classes of decision makers rather than to particular decision makers," specifically, "is the disclosure intelligible to the audience for which it is intended? (p. 15)" FASB recognizes that "... understandability of information is a prerequisite to the information being useful to particular decision makers (p. 34)." In short, information cannot be useful if it not understandable.

"Usefulness" in Existing Standards?

So, if the concept statements will potentially be considered GAAP (nonauthoritative, albeit), one could infer that by incorporating the Concepts Statements into nonauthoritative GAAP, FASB is raising the bar relative to the usefulness of reported information. How will this translate for auditors?

SFAC 2 lists two primary decision-specific qualities for information to be useful, i.e., relevance and reliability. Each primary quality has several ingredients: predictive value, feedback value, and timeliness (for relevance) and verifiability and representational faithfulness (for reliability). Auditors do not currently audit for the primary decision-specific quality of relevance, nor do they audit for its ingredients, i.e., predictive value, feedback value, and timeliness.

Reliability is a different issue. Auditors routinely audit assertions for occurrence, completeness, accuracy, existence, classification and understandability, and valuation. These assertions seem to address reliability and its ingredients of verifiability and representational faithfulness. One can conclude, then, that auditors audit for one of the two dimensions of
information usefulness already. Can the audit of the other dimension, relevance and its components of predictive value and feedback value and timeliness, be far over the horizon? Does the elevation of "usefulness" into GAAP not push the profession in this direction?

Impact on the "Expectations Gap"

At the very least, will including the concepts in the GAAP hierarchy further widen the "audit expectation gap" – defined by Liggio (1974) as the difference between financial statement user expectations of the audit and the expectations of the independent accountant. Perhaps a change in the stated audit objective may not occur, but—if the concepts become more fully integrated into GAAP hierarchy—will the users, including the preparers of financial statements, begin to expect the auditor to consider the items that make up "relevance" of financial information?

Questions

Should the change in audit objective actually occur, other questions are raised: Who could bring a suit against the auditor and claim that the financial statements do not provide useful information? Who would have the burden of proof? As preparers of the financial statements, what is management's liability?
References


